

INTERNAL REVENUE CODE SECTION 1034: SALE OF A RESIDENCE TO A RELATED CORPORATION — A VIABLE STRATEGY?

Tax attorneys and accountants recently have devised a tax strategy by which a homeowner, desiring to sell his old principal residence but unable to do so because of a buyer's market, can overcome the two-year limitation period of Internal Revenue Code section 1034. The strategy requires the formation of a legitimate corporation to act as the buyer and the transfer of the homeowner's old principal residence to the newly formed corporation to be recognized as a sale. However, the newly formed corporation is likely to be disregarded and in the event that it is not disregarded, the transfer is likely to be characterized as a section 351 transfer or a capital contribution, not a sale. Consequently, under both the current tax law and the proposed Tax Reform Act of 1986, such a tax strategy will not prove to be a viable means of overcoming section 1034's two-year limitation period.

INTRODUCTION

Subject to certain limitations, Internal Revenue Code (Code) section 1034¹ allows a taxpayer to postpone recognition of a gain from the sale of an old principal residence when the sale occurs within two years of the purchase of a new principal residence.² This provision was enacted to eliminate the hardship faced by a homeowner having to pay taxes on a gain which was to be reinvested in a new home.³

1. I.R.C. § 1034 (West 1982 & Supp. 1986).

2. Under section 1034(a), gain need not be recognized to the extent that the taxpayer's cost of purchasing a new residence is equal to or greater than the adjusted sales price of the old residence. "Adjusted Sales Price" is defined under section 1034(b); explanation of the computation can be found in Treasury Regulation Section 1.1034-1(c)(2). To the extent that gain is realized (when the sales price of the old residence, minus selling and fixing-up expenses, exceeds the taxpayer's basis) but is not recognized, the basis of the new residence is decreased by the amount of gain not recognized. Thus, the amount of gain not recognized from the sale of the old residence will not be taxed until the new residence is sold.

3. H.R. REP. NO. 586, 82d Cong., 1st Sess. 27, reprinted in 1951 U.S. CODE

Although section 1034 is designed to help the taxpayer, the two-year limitation period has prevented many homeowners, unable to sell their homes within that time, from taking advantage of the provision. Consequently, a recent trend of utilizing a sale-to-a-related-corporation tax plan (Plan) has emerged in these situations.

The Plan is best illustrated by a hypothetical. Assume T (a homeowner under the age of 55)⁴ bought a home for \$100,000 in 1975. T paid \$25,000 in cash and took out a mortgage for the remaining balance of \$75,000, at an interest rate of 10% per annum. In 1983 T buys a new home for \$300,000 and puts his old home on the market. In 1985 near the expiration of the section 1034 two-year limitation period, T still is unable to find a buyer for his old home. Thus, T forms a wholly owned⁵ corporation (X), adhering to all corporate formalities (such as filing corporate tax returns, maintaining a corporate checking account and designating corporate officers). T contributes \$10,000 to X's working capital⁶ in exchange for all of X's stock.⁷ Furthermore, T elects to operate X as an "S" corporation.⁸ Subsequently, within the section 1034 two-year limitation period, T sells his old residence to X at the fair market value of \$250,000. X assumes T's mortgage (by 1985 the principal has decreased from \$75,000 to \$50,000) and issues five promissory notes to X, each in the principal amount of \$40,000 and bearing interest at the rate of 10% per annum.⁹ The first note is payable one year from the sales

CONG. & AD. NEWS 1781, 1808; S. REP. NO. 781, 82d Cong., 1st Sess. 34-35, *reprinted in* 1951 U.S. CODE CONG. & AD. NEWS 1969, 2004.

4. For purposes of this Comment, T is assumed to be younger than 55 years of age; otherwise, I.R.C. § 121 (West 1984) also would need to be consulted.

5. As used in the text, a corporation is wholly owned when all of its stock is owned, be it actual or constructive ownership, by one person.

6. Working capital, as referred to in the text, is the amount of cash available to pay for X's operational expenses, including maintenance, property insurance, and property taxes.

7. Under I.R.C. § 118(a) (West 1984) capital contribution to a corporation does not result in gross income to the corporation. Similarly, under I.R.C. § 1032(a) (West Supp. 1986), "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock . . . of such corporation."

8. *See generally* I.R.C. §§ 1361-1379 (West Supp. 1986). Generally, under section 1361, a corporation with no more than 35 shareholders and no more than one class of stock may elect to be an "S" corporation under section 1362. The primary advantage of such an election is the avoidance of double taxation and the ability to pass-thru corporate losses. That is, each shareholder reports his pro rata share of the corporation's gains or losses on his individual tax return, thereby avoiding tax at the corporate level, or, in the event of a loss, the loss is deducted against the taxpayer's personal income.

9. For the purpose of this Comment, it is assumed that a 10% interest rate is adequate under I.R.C. § 483 (West Supp. 1986), *amended by* Amendments to Imputed Interest Rules, Pub. L. No. 99-121, § 101, 99 Stat. 505, 505-09 (1985); *cf.* Act of Oct. 31, 1984, Pub. L. No. 98-612, § 2, 98 Stat. 3180, 3182-85 (in real estate installment sale contracts entered into after 1984, but before July 1, 1985, if no interest rate is specified and section 483 applies, a 10% rate is imputed). Under section 483, the lack of an adequate interest rate results in a recharacterization of a portion of the principal as interest (referred to as the "unstated interest"); consequently, the purchaser's basis in the prop-

date, with each successive note maturing at one-year intervals. The old residence, which X acquired, then is rented at its fair market value of \$1200 per month for a few years until it is sold to a third-party buyer. During each of these rental years, X deducts \$5000 for expenses,¹⁰ approximately \$25,000 for interest payments,¹¹ and \$10,000 for depreciation (assuming a useful life of twenty-five years, calculated under the straight-line method).¹² The difference between

erty is decreased by the amount of the unstated interest. Treas. Reg. § 1.483-2(a)(1)(i) (1966). Assuming the property is depreciable, such decrease in basis would lead to smaller depreciation deductions.

10. Expenses include property taxes, property insurance, and costs of maintaining the property. Property taxes are deductible under I.R.C. § 164(a)(1) (West 1978). Property insurance and maintenance costs may be deducted under I.R.C. § 162(a) (West 1978) when such expenses are "ordinary and necessary" to the carrying on of a "trade or business." See, e.g., *Ohio County & Indep. Agriculture Socy's, Del. County Fair*, 51 T.C.M. (P-H) ¶ 82-210, at 876 (1982) (the renting of a single parcel of real estate qualifies as a "trade or business"); *Waldheim Realty & Inv. Co. v. Commissioner*, 245 F.2d 823, 825 (8th Cir. 1957) (insurance premiums are deductible business expenses); *James L. Dowsey*, 9 B.T.A.M. (P-H) ¶ 40,297, at 453 (1940) (property maintenance costs are deductible business expenses).

11. The fact that part of the interest payment is owed to a related shareholder does not preclude deductibility under I.R.C. § 163(a) (West 1978) in cases in which a bona fide debt exists. E.g., *R-W Specialties, Inc.*, 50 T.C.M. (P-H) ¶ 81,697 (1981); cf. I.R.C. § 267(a)(2) (West Supp. 1986) (interest owed to a related party may be deducted only if the payor and the payee use the same accounting method with regard to the interest payment(s)). Thus, the amount of interest deduction is 10% of \$50,000 (principal of assumed mortgage) plus 10% of \$200,000 (principal of total promissory note issued by X). This in turn is equivalent to \$5000 plus \$20,000, respectively, yielding a total deduction of \$25,000 per year. For the purposes of this Comment, it is assumed that \$25,000 represents the annual interest deduction, although, the amount realistically would be somewhat smaller in subsequent years due to the decrease in the amount of principal owed on the mortgage.

12. Under both I.R.C. § 167(a) (West Supp. 1986) and I.R.C. § 168(c)(1) (West Supp. 1986) property may be depreciated if it is used in a trade or business or held for the production of income. The difference between the two sections is that under section 168 a greater amount of depreciation per year may be deducted because the length of time in which certain properties may be depreciated is shortened. For example, under section 168, most real properties may be depreciated in 18 years; under section 167, the period of depreciation is determined by the particular property's approximate useful life which normally exceeds 18 years. Nonetheless, section 168 is subject to numerous limitations, several of which are applicable in the hypothetical case.

First, under section 168(e)(1), depreciable property must be acquired after December 31, 1980. Second, for purposes of applying section 168, even property acquired after 1980 is not treated as such if at any time during 1980: 1) the purchaser was a corporation; and 2) the seller was at least a 10% shareholder in the purchaser-corporation. See I.R.C. § 168(e)(4)(B), (D). Third, under subsection 168(e)(4)(C), if the acquisition of the property constitutes a transfer subject to section 351, see *infra* text accompanying notes 62-88, section 168 will not apply to the extent that the basis of the property is determined by the transferor's basis. Thus, in the hypothetical case, section 168 is not applicable not only because the acquisition is likely to constitute a section 351 transfer, but also because T, an owner of more than 10% of X's outstanding stock, had owned the

X's rental income and its allowable deductions yields an annual loss of \$25,600.¹³

From the above hypothetical transactions, it must be determined whether T has succeeded in bringing the "sale" within the ambit of section 1034 to produce a loss, deductible on his individual tax return. Arguably, T's sale of the house to X not only enabled T to meet the section 1034 two-year limitation period but also permitted T to transfer the property to X with a step-up in basis¹⁴ for depreciation.¹⁵ The step-up in basis results in a significant increase of deductible depreciation — in this hypothetical, the step-up in basis has resulted in an additional \$6000 deductible depreciation per year.¹⁶

property purchased by X in 1980. Consequently, depreciation is appropriately determined under section 167.

In determining the method of depreciation, the applicable provision is section 167(j)(5) which pertains to used, section 1250 property. Section 1250 property is defined as depreciable property which is not included under section 1245(a)(3). I.R.C. § 1250(c) (West 1982). Section 1245(a)(3) excludes buildings, such as houses. I.R.C. § 1245(a)(3) (West 1982 & Supp. 1986). Therefore, houses used as rentals are considered section 1250 property. Under section 167(j)(6), property whose original use is later converted to a depreciable use is considered "used" property. Thus, under section 167(j)(5), X may use the straight-line method of depreciation — the basis of the property divided by the term of useful life. Other accelerated depreciation methods also are available but will be subject to section 1250 recapture rules to the extent that it is greater than the annual amount allowed under the straight line method. *See infra* notes 118-21 and accompanying text.

It must be noted that if T had owned his residence after 1980, rather than after 1975, and X had acquired the property sometime thereafter, X would be allowed to use section 168, assuming that the acquisition does not constitute a section 351 transfer. Nevertheless, section 168(f)(10) limits the basis of depreciation to that of T's old basis (i.e. \$100,000). Furthermore, if the Tax Reform Act of 1986 is passed, under section 168, residential rental property acquired after December 31, 1986 will be limited to the straight-line method of depreciation over a period of 27.5 years. H.R. 3838, 99th Cong., 2d Sess., § 1802 (1986).

13. Allowable deductions: Expenses \$5000
Interest \$25,000
Depreciation \$10,000
TOTAL \$40,000

Gross income: \$1200 x 12 months = (equals) \$14,400. Thus, X's total allowable deductions of \$40,000 exceed its gross income of \$14,400 netting a loss of \$25,600.

14. A "step-up" in basis refers to the new, higher basis in the property transferred. Under I.R.C. § 1012 (West 1982) the basis of property is the cost of such property. Included in the term "cost" is the money paid and the amount of any mortgages. *See Crane v. Commissioner*, 331 U.S. 1 (1947). Thus, assuming T incurred no expenses in selling his old residence and that the transfer is not a section 351 exchange, the difference between \$250,000 (the price received for his old residence) and \$100,000 (the basis of his old residence) resulted in a \$150,000 step-up in basis for X.

15. Under I.R.C. § 1239 (West 1982 & Supp. 1986), gain from a transfer of property, depreciable in the hands of the transferee, to a related party is characterized as ordinary income to the transferor, not capital gain; however, since gain from a section 1034 transfer is not recognized, section 1239 does not apply until the transferor's new residence is sold. *See infra* note 140. Additionally, if the Tax Reform Act of 1986 should pass, section 1239 will continue to be relevant, since the distinction between capital gains and ordinary income is referred to throughout various Code provisions.

16. Depreciation calculated under the straight-line method over a useful life of 25 years, with the old basis of \$100,000, yields an annual depreciation deduction of \$4000. On the other hand, with the new basis of \$250,000 the depreciation is increased to

Accordingly, the higher amount of deductible depreciation contributes to a greater amount of total allowable deductions per year. Moreover, because X is an "S" corporation, T, as X's sole shareholder, may deduct the entire \$25,600 loss against his personal income on his individual tax return.¹⁷

It should be noted that if the Tax Reform Act of 1986 passes, rental activity will be considered a passive activity.¹⁸ Business and interest expenses attributable to rental activity will not be included in the determination of a passive activity's income or losses. Furthermore, loss deductions will not be permitted unless the passive activity has net active income from which to be offset or the taxpayer owns at least 10% of the interest in the passive activity and has an adjusted gross income of less than \$150,000.¹⁹ (A taxpayer with adjusted gross income of \$100,000 or less will be entitled to deduct up to \$25,000 in passive activity losses; a taxpayer with an adjusted gross income exceeding \$100,000 will be entitled to deduct losses only to the extent of \$25,000 less 50% of the adjusted gross income exceeding \$100,000 — that is, at an adjusted gross income of \$150,000 the exemption is phased out).²⁰ Disallowed losses are carried over to the succeeding taxable years and, upon disposition of the taxpayer's entire interest in the passive activity, such losses can be deducted against income in the following order: gain recognized on the disposition, net income or gain from all passive activities, and any other income or gain.²¹ Consequently, depending upon T's annual adjusted gross income, the Tax Reform Act of 1986 would limit T's annual loss deduction — if not altogether postpone it — until T disposes of his entire interest in the rental activity.

The advantages to be gained from implementing the Plan increase

\$10,000, resulting in a difference of \$6000.

17. I.R.C. § 1366(a) (West 1986) permits the pass-thru of a corporation's income, losses, deductions, and credits to its shareholder(s); however, under section 1366(d)(1), a shareholder may take only so much of the losses and deductions as shall not exceed his adjusted basis in the corporation's stock and any indebtedness of the corporation to the shareholder. In our hypothetical, T's initial basis in the corporate stock is \$10,000 (the amount of T's initial capital contribution) and the basis of the indebtedness owed to him by X is \$200,000 (the cumulative total of the promissory notes). Thus, T may continue to take losses and deductions so long as they are less than his combined basis of \$210,000 (\$200,000 plus \$10,000) less adjustments made under I.R.C. § 1367 (West Supp. 1986).

18. H.R. 3838, 99th Cong., 2d Sess. § 501 (1986) (to be enacted as section 469 of the Code).

19. *Id.*

20. *Id.*

21. *Id.*

with the value and appreciation of the home (hereinafter "property") sold.²² The Plan serves to benefit those taxpayers owning highly appreciated property who are likely to be in the highest income tax bracket.²³ Moreover, although tax-minimization schemes involving related parties frequently are attacked by the Internal Revenue Service (IRS), the Plan appears to find some support from the IRS.²⁴ Thus, for these high-bracket taxpayers, the Plan is an attractive tax saving strategy.

This Comment explores the Plan's legitimacy and viability as a tax strategy. The Comment first discusses whether a Plan-devised corporation will be recognized as a legitimate entity, separate from the homeowner-taxpayer. If the corporation is not recognized as a separate entity, the Plan becomes useless because it is premised upon the corporation acting as the buyer. Second, the transfer of the homeowner's property to the corporation is examined in light of section 351,²⁵ which is of particular importance in determining the extent, if any, of the tax benefits to be derived under the Plan. Third, the Comment briefly explores the potential tax consequences likely to follow when a third party buyer is found and a corporate sale follows. Fourth, IRS Letter Ruling 8350084 is examined with respect to its effect upon the legitimacy of the Plan. Ultimately, the Comment concludes that under close analysis, the Plan-devised corporation is neither a legitimate nor a viable tax saving strategy.

22. For example, if property with a fair market value and basis of \$100,000 is later sold at the appreciated fair market value of \$150,000, the basis subject to depreciation has increased by \$50,000. But if the property instead had appreciated to \$300,000, the basis subject to depreciation would increase by \$200,000. Thus, the more a property appreciates, the greater will be the basis subject to depreciation, and therefore the greater the amount of depreciation deduction. Consequently, the higher the depreciation deduction, the lower the income subject to taxation.

23. As an illustration, assume A and B each owns a home which has a basis and fair market value of \$50,000. Furthermore, assume A is in the 25% tax bracket and B is in the 50% tax bracket. At the time of disposition, each home is sold at the fair market value of \$150,000. Each home has thus appreciated by \$100,000 and, under I.R.C. § 1001(a) (West 1982), both A and B have realized a taxable gain of \$100,000. Nonetheless, since a home does not fall within any of the categories excluded by section 1221's definition of capital asset, A and B are entitled to treat the \$100,000 as a capital gain. Accordingly, under I.R.C. § 1202 (West 1982) A and B each may deduct 60% of the gains, leaving an adjusted taxable gain of \$40,000 (\$100,000 — 60% of \$100,000). Consequently, A's tax is \$10,000 (25% of \$40,000) and B's tax is \$20,000 (50% of \$40,000). On the same amount of gain/appreciation, B pays twice as much as A in taxes. Therefore, given the same transaction, when gain is not recognized under section 1034, or when a deductible loss results, B will save more than A in taxes.

24. LTR 8350084 (September 13, 1983). See *infra* notes 137-42 and accompanying text.

25. I.R.C. § 351 (West 1978 & Supp. 1986). Generally, if a transfer is characterized as a section 351 exchange no gain or loss may be recognized on the transaction — that is, there is no sale. See *infra* notes 62-88 and accompanying text for a further discussion of section 351 transfers.

THE CORPORATION AS A SEPARATE ENTITY

As a general principle, a corporate entity is recognized rather than disregarded for tax purposes.²⁶ Nevertheless, the treatment of a corporation as a separate entity frequently depends upon the existence of a business purpose.²⁷ Usually, courts have been lenient in finding the existence of a business purpose and in thus upholding the corporate entity; however, it is important to note that such findings generally have occurred in cases in which the existence of a corporate entity favors the Commissioner of the Internal Revenue Service (Commissioner).²⁸ Moreover, the fact that a corporation is owned wholly by one shareholder has not subjected the corporation to any less recognition as a separate entity.²⁹ But, if the existence of a corporate entity is deemed a sham, an exception to the general principle is recognized.³⁰ Accordingly, if a newly formed corporation under the Plan, as illustrated in the hypothetical, fails to satisfy the business purpose requirement or is deemed a sham, the corporate entity will not be recognized and thus cannot act as the buyer. Without the Plan-devised corporation acting as the buyer, there is no sale. Without a sale, there is no gain. And without a gain, the taxpayer cannot obtain the benefits of a stepped-up basis nor utilize section 1034's nonrecognition provision. Consequently, the Plan would not be a viable nor legitimate means of obtaining the tax benefits discussed above.

26. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 442 (1934); *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 439 (1943); *Britt v. United States*, 431 F.2d 227, 233 (5th Cir. 1970); *Dooley v. Commissioner*, 48 T.C.M. (CCH) 1372, 1375 (1984).

27. Samuels, *The Limited Role of Section 351 in Corporate Acquisitions*, 60 TAXES 955, 967 (1982); Comment, *The Business Purpose Doctrine: The Effect of Motive on Federal Income Tax Liability*, 49 FORDHAM L. REV. 1078, 1084 (1981). For a general analysis of the development of the business purpose doctrine, see Lipnick, *Business Purpose and Income Taxes: From Gregory to Goldstein*, 46 TAXES 698 (1968).

28. See *infra* notes 36-43 and accompanying text.

29. *E.g.*, *Burnett v. Commonwealth Improvement Co.*, 287 U.S. 415, 419 (1932); *Hargrave v. Fibreboard Corp.*, 710 F.2d 1154, 1162 (5th Cir. 1983); *Machinery Rental, Inc. v. Herpel*, 622 F.2d 709, 725 (5th Cir. 1980); *Bendix Home Sys., Inc. v. Hurston Enters., Inc.*, 566 F.2d 1039, 1042 (5th Cir. 1978); *DeWitt Truck Brokers v. W. Ray Fleming Fruit Co.*, 540 F.2d 681, 683 (4th Cir. 1976); *Robertson v. Roy L. Morgan, Prod. Co.*, 411 F.2d 1041, 1043 (10th Cir. 1969).

30. *E.g.*, *Higgins v. Smith*, 308 U.S. 473 (1940); *Gregory v. Helvering*, 293 U.S. 465 (1935).

The Business Purpose Requirement

Whether a corporation's existence as a separate entity will satisfy the business purpose requirement will depend upon the character of its activities.³¹ In *Moline Properties, Inc. v. Commissioner*,³² the United States Supreme Court held that a corporation will be treated as a separate entity if the corporation's "purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation"³³ In *National Investors Corp. v. Hoey*,³⁴ Judge Learned Hand applied the *Moline* rationale, defining business activity as "some industrial, commercial, or other activity besides avoiding taxation."³⁵ It can be observed from Judge Learned Hand's definition that a corporation's activities need not be substantial so long as the corporation's purpose is not confined to tax avoidance.

In practice, the amount of business activity required of the corporation has been minimal.³⁶ For example, in *Britt v. United States*,³⁷ the taxpayer formed three corporations, one for each of his three children, and subsequently transferred to each corporation an interest in the taxpayer's fruit business. The corporations were formed for three purposes: to encourage the taxpayer's children to become involved in his business; to provide the taxpayer's children with a source of income; and, to facilitate the taxpayer's estate planning.³⁸ After concluding that *Moline* required only a minimal level of business activity, the court held that the corporations' executions of mortgages, holding of stock, and accrual and disbursements of income made in the corporate name, constituted sufficient business activity to uphold the corporations as separate entities.³⁹

In *Commissioner v. State-Adams Corp.*,⁴⁰ the corporation was formed to facilitate the distribution of the decedent's estate. In particular, the corporation's purposes were to hold title to specific property which the decedent wished to preserve for her children, and to distribute to these children the rent earned from the property. The corporation's activities were limited to some ten directors' meetings in which occasional modifications were made regarding the distribution of the rental income. In holding these activities sufficient, the

31. Some tax attorneys refer to this test as the "business activity" test.

32. 319 U.S. 436 (1943).

33. *Id.* at 439.

34. 144 F.2d 466 (2d Cir. 1944).

35. *Id.* at 468.

36. *E.g.*, *Strong v. Commissioner*, 66 T.C. 12, 24 (1976) ("The degree of corporate purpose and activity requiring recognition of the corporation as a separate entity is extremely low.").

37. 431 F.2d 227 (5th Cir. 1970).

38. *Id.* at 229.

39. *Id.* at 237.

40. 283 F.2d 395 (2d Cir.), *cert. denied*, 365 U.S. 844 (1960).

court noted that such activities were all that was required to carry out the purpose for which the corporation was formed.⁴¹

And in a recent Tax Court case, *Robert Delli Paoli*,⁴² property was transferred to the taxpayer's wholly owned corporation for the sole purpose of limiting the taxpayer's personal liability to potential creditors. Subsequently, the corporation sold the property. The tax court held that the advantage gained by the taxpayer in avoiding potential liability and the corporation's disposition of the property was sufficient business activity to satisfy the requirements of *Moline*.⁴³

From the above cases it becomes clear that the business purpose requirement may be satisfied if the corporation engages in activity which, although minimal, is sufficient to carry out the purpose of the corporation's being. Moreover, the creation of a corporation for the purpose of shielding oneself from personal liability also may be sufficient business activity. Both contentions may be made by our hypothetical Plan-devised corporation. Nonetheless, the above cases can be distinguished from the hypothetical because such cases involved business-type properties, and the hypothetical essentially involves a nonbusiness-type property (a residence) converted for commercial usage (rental). Whether this is a viable distinction is uncertain: it has yet to be asserted. In light of the current case law, however, it appears that X is likely to succeed in satisfying the business purpose requirement, unless of course the transaction is deemed a sham.⁴⁴

41. *Id.* at 399.

42. 49 T.C.M. (CCH) 1292 (1985).

43. *Id.* at 1296; *see also* *Dooley v. Commissioner* 48 T.C.M. (CCH) 1372, 1376-77 (1984) ("Gene's express purpose in forming Enterprises was to shield himself from personal liability. This is an advantage under Missouri law that he would not otherwise have enjoyed without the intervention of the corporate form and is thus the equivalent of business activity.").

44. *E.g., Moline Properties, Inc.*, 319 U.S. at 439; *Jan T. Williams*, 47 T.C.M. (CCH) 846, 848 (1984). Additionally, if a wholly owned corporation transacts business in the name of its sole shareholder and thereby binds such shareholder by its acts, it theoretically may be disregarded on the basis that it is merely a nominee or alter-ego of the shareholder. *Dooley*, 48 T.C.M. (CCH) at 1378-79; *see also* *National Carbide Corp. v. Commissioner*, 336 U.S. 422, 437 (1949). In recent years, however, courts have come to reject disregarding a corporation on the basis of a nominee or alter-ego argument, applying instead the business purpose doctrine. *See Miller, The Nominee Conundrum: The Live Dummy is Dead, but the Dead Dummy Should Live* 34 TAX L. REV. 213 (1979).

Sham Transaction Doctrine

It is well settled that a taxpayer has the right to structure a business transaction in such a way as to minimize taxes, if not all together to avoid them.⁴⁵ Nonetheless, if the taxpayer's exercise of his right is motivated primarily or solely to avoid taxes,⁴⁶ or if in substance the transaction is "created to contravene directly or indirectly the policies of the Internal Revenue Code,"⁴⁷ the courts have held the transaction to be a sham. In applying the sham transaction doctrine, courts look to the substance and not the mere form of the transaction.⁴⁸ The Supreme Court has stated that "[t]o permit the true nature of a transaction to be disguised by mere formalism, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."⁴⁹

The classic illustration of the substance over form dichotomy can be found in *Gregory v. Helvering*.⁵⁰ Taxpayer, Gregory, sought to transfer to herself certain stocks held by her existing wholly owned corporation for the purpose of selling the same stocks to a third party. As a means of diminishing the amount of taxes which would accrue upon a direct transfer by way of a dividend, Gregory formed a new corporation and transferred to it the desired stocks under the guise of a reorganization. Six days after its inception, Gregory liquidated the new corporation and distributed to herself the desired stocks, taxable at the lower capital gain rate. Although the form of Gregory's transactions complied with the literal language of the particular Code section, the Supreme Court held that the substance of the transactions did not constitute a reorganization, as intended by the Code,⁵¹ and thus the Court disregarded the newly formed corpo-

45. *E.g., Gregory*, 293 U.S. at 469; *Shaw Constr. Co. v. Commissioner*, 323 F.2d 316, 319 (9th Cir. 1963); *Jan T. Williams*, 47 T.C.M. (CCH) at 848.

46. *E.g., Shaw*, 323 F.2d at 320.

47. *Britt*, 431 F.2d at 233.

48. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

49. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945).

50. 293 U.S. 465 (1935).

51. In *Gregory*, the court indicated:

the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" [section 112(g)] of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here [W]hat . . . we find . . . [is] a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.

Id. at 469.

rate entity.⁵²

A corporation was held to be a sham for purposes of a specific transaction in *Higgins v. Smith*.⁵³ In *Smith*, the taxpayer "sold" certain stocks to his wholly owned corporation and claimed a loss on his tax return. Recognizing the transaction as a mere paper loss, the Supreme Court noted that the "domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity."⁵⁴ Subsequently, Congress codified the *Smith* decision in section 267⁵⁵ which prohibits the recognition of a loss from the sale of property between certain related parties, including an individual and his wholly owned corporation.⁵⁶

The principle underlying the *Gregory* and *Smith* decisions is that arrangements which distort and defeat the basic purpose for which a claimed deduction, credit, or allowance was created may be disregarded. In *Gregory*, the taxpayer claimed an allowance which was permissible only in a bona fide reorganization. Since the taxpayer's formation of a new corporation, liquidated six days later, was held not to be a reorganization within the intent of the Code, permitting such an allowance would distort and defeat the basic purpose for which the allowance was created. Similarly, in *Smith*, the basic purpose of the claimed deduction was to offset a taxpayer's business losses. Since the taxpayer's losses in *Smith* were manufactured, as opposed to actually incurred, no deduction could be permitted without distorting and defeating the purpose of the loss deduction.

The above principle has been codified under section 269⁵⁷ and has been addressed in the accompanying regulations.⁵⁸ For the purposes of this Comment, section 269 generally disallows a taxpayer's claim for a deduction, credit or other allowance which otherwise is made possible by acquiring control of a corporation of which the *principal*

52. *Id.* at 470.

53. 308 U.S. 473 (1940).

54. *Id.* at 476.

55. I.R.C. § 267 (West 1978 & Supp. 1986).

56. *Id.* § 267(b)(2).

57. I.R.C. § 269 (West 1978 & Supp. 1986). As stated in S. REP. NO. 627, 78th Cong., 1st Sess. 58 (1943),

the legal effect of the section is, in large, to codify and emphasize the general principle set forth in *Higgins v. Smith*, . . . and in other judicial decisions, as to the ineffectiveness of arrangements distorting or perverting deductions, credits, or allowances so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them and for the benefit of which they were provided.

58. Treas. Reg. § 1.269-2(b) (1962).

purpose of the acquisition is tax avoidance. Tax avoidance is the principal purpose if it "outranks or exceeds in importance, any other one purpose."⁵⁹

Analyzed under the sham transaction doctrine, certain aspects of the Plan indicate that X may be disregarded as a corporation in its "sale" transaction with T. First, in all likelihood and reasonableness, the intent of section 1034 is to allow nonrecognition of gains in instances involving a taxpayer and an unrelated party or a related party if the evidence suggests an arms-length transaction. It is doubtful that section 1034, requiring a sale or exchange, ever was intended to encompass those transfers between a taxpayer and his newly formed, wholly owned corporation. This is true especially in cases in which the corporation acquires the property in order to engage in a loss producing business. A transaction between such parties compels the conclusion that the transfer was anything but arms-length.

Second, T's creation of a corporate entity enabled T to produce and claim a deductible loss as economically unreal as that claimed in *Smith*. As an illustration, without the corporate entity to act as a buyer, the only deductions to which T would be entitled are \$5000 for maintenance expenses, \$5000 for interest paid on the original mortgage, and \$4000 for depreciation (\$100,000 basis divided by a useful life of 25 years).⁶⁰ The difference between the rental income (\$14,400) and the allowable deductions (\$14,000) yields a *gain* of \$400. By forming a corporate entity and selling to it highly appreciated property, T has created a deductible loss out of an otherwise taxable gain. Such an arrangement is analogous to what the Supreme Court in *Smith* described as "simply 'a transfer by Mr. Smith's left hand, being his individual hand, into his right hand, being his corporate hand, so that in truth and fact there was no transfer at all.'"⁶¹

Third, X was formed for the principal purpose, if not the sole purpose, of avoiding taxes. In particular, X is used as a vehicle to obtain section 1034 benefits and to create a step-up in basis for depreciation. Consequently, T's transaction may come within the ambit of section 269. Thus, notwithstanding IRS Letter Ruling 8350084, discussed below, and the possibility that X may satisfy the business purpose requirement, the tax avoidance purposes inherent in the Plan coupled with the opposite intentions of section 1034 implicate a probable application of the sham transaction doctrine.

59. S. REP. NO. 627, 78th Cong., 1st Sess. 59 (1943).

60. See *supra* notes 10-12 for authority supporting the deductibility of such expenses.

61. *Smith*, 308 U.S. at 475.

BONA FIDE SALE V. SECTION 351 TRANSFER

If a Plan-devised corporation is deemed legitimate because it satisfies the business purpose requirement and is not subject to the sham transaction doctrine, its "sale" transaction still may be subject to attack under section 351. Section 351(a) provides that

[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.⁶²

At the outset, it is necessary to note that the control addressed in section 351 need not be a result of the transfer if the transferor already was in control of the corporation prior to the exchange.⁶³ In a wholly owned corporation consisting of one shareholder, the control element always is satisfied.⁶⁴ Thus, whether a transaction falls under section 351 more often than not has turned upon the interpretation of "securities."

Litigation involving interpretation of the term "securities" often arises in section 351 cases. Whether a debt incurred on an apparent sale should be characterized as a section 351 security or a bona fide debt is one of the most frequently litigated issues. Ordinarily, the issue arises when the taxpayer has transferred property to his wholly owned corporation in the form of a sale, and, subsequently, the corporation takes depreciation deductions at the higher purchase price basis (as opposed to the transferor's basis) and/or sells the property, claiming gain as the difference between its purchase price and the sales price. In these instances, the IRS maintains that a transfer which a shareholder has treated as a sale is in reality a transfer of property for securities.⁶⁵ Additionally, due to the similarity in analysis, the IRS also may argue that the transfer should be treated as a capital contribution.⁶⁶

If a transfer is classified as a section 351 exchange, and not a sale, the corporation's basis in the property received, under section

62. I.R.C. § 351(a) (West 1978 & Supp. 1986).

63. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 3.08, at 3-33 (abr. 4th ed. 1979).

64. I.R.C. § 368(c) (West Supp. 1986) defines "control" as owning 80% or more of the voting stock and 80% or more of all other classes of stock. In a wholly owned corporation, the sole shareholder owns 100% of all stock.

65. *E.g.*, *Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116 (5th Cir. 1959).

66. *E.g.*, *Burr Oaks v. Commissioner*, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007 (1967).

362(a),⁶⁷ is the same as it was in the hands of the transferor prior to the exchange, and, consequently, no gain may be recognized. As previously discussed, without a gain one cannot obtain the benefits of a step-up in basis and cannot utilize section 1034's nonrecognition provision.

Security v. Debt

Whether a promissory note in exchange for property will be treated as a security or as a debt requires a consideration of several factors. A promissory note, to be treated as a debt, must have a fixed-maturity date, fixed-interest payments, no subordination to general creditors, and no voting rights.⁶⁸ Additionally, even if a promissory note on its face evidences a debt, the length of time to its maturity will play a key factor in the debt determination.⁶⁹

Generally it is recognized that an obligation which matures in five years or less will likely be treated as a debt.⁷⁰ The underlying premise is that the longer the period to maturity, the greater the risk that the obligation will not be repaid. A high degree of risk is analogous to the continuing proprietary interest of a shareholder because both the creditor and the shareholder depend upon the venture's continued success for the repayment of their investment.⁷¹ Thus, the distinction between a long-term debt and a security held by a shareholder tends to be blurred, inviting challenge from the IRS.

Assuming that a promissory note contains all the indicia of a debt and is payable within five years, it still may be considered a security if certain circumstances exist.⁷² In particular, the failure of a related

67. I.R.C. § 362(a) (West 1978).

68. B. BITTKER & J. EUSTICE, *supra* note 63, ¶ 4.04, at 4-10; *see also* I.R.C. § 385(b) (West 1978). Section 385(b) enumerates several factors which the IRS may include in the Code regulations as guidelines in determining whether an interest in a corporation is to be treated as indebtedness or stock. The suggested factors are similar to those cited in the text; however, the IRS thus far has failed to pass any such regulations under section 385.

69. TAX MGMT. (BNA) No. 347, A-33 (1978).

70. *Id.* at A-34; B. BITTKER & J. EUSTICE, *supra* note 63, ¶ 3.04, at 3-16 to 3-17; *see also* Bradshaw v. United States, 683 F.2d 365, 377 n.28 (Ct. Cl. 1982); Adams v. Commissioner, 58 T.C. 41, 56-57 (1972); Raich v. Commissioner, 46 T.C. 604, 612-13 (1966).

71. *See, e.g.,* Bradshaw, 683 F.2d at 376-77; United States v. Hertwig, 398 F.2d 452, 455 (5th Cir. 1968); Burr Oaks Corp. v. Commissioner, 365 F.2d 24, 27 (7th Cir.), *cert. denied*, 385 U.S. 1007 (1966); Aqualane Shores, Inc. v. Commissioner, 269 F.2d 116, 119 (5th Cir. 1959); Camp Wolters Enters. v. Commissioner, 230 F.2d 555, 560 (5th Cir.), *cert. denied*, 352 U.S. 826 (1956).

72. "The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. . . ."

corporation to pay its shareholder-creditor the principal amount and/or interest on a promissory note when due is a persuasive factor in disregarding a debt.⁷³ Moreover, a promissory note is likely to be characterized as a security when the property transferred becomes the primary earning asset of the corporation and such property fails to generate enough earnings to cover the expenses and debts accompanying the corporation's acquisition.⁷⁴

In sum, the following factors have been important in persuading a court that a debt instrument should be treated as a section 351 security: the instrument lacks one or more of the indicia of a debt; a maturity date of five years or longer; failure to pay interest and principal when due; the property transferred becomes the corporation's principal earning asset; and, the property transferred fails to generate enough income to satisfy its debts and expenses.

In the hypothetical facts, T's old residence, which has been converted to rental property, is the primary earning asset of X because it is X's sole source of income. T's capital contribution of \$10,000, together with X's annual income of \$14,400, are not enough to satisfy the annual liabilities consisting of expenses (\$5000), interest owed on the assumed mortgage and issued notes (\$25,000), and principal owed on the issued notes (\$40,000).⁷⁵ Consequently, X has only two choices: elect not to pay the principal and interest due on the notes issued to T or elect to extend the time of maturity on the issued notes together with avoiding interest payments on the notes.⁷⁶ But election of either of these alternatives strengthens the security argument;⁷⁷ moreover, the reasoning behind section 351 indicates that the promissory notes issued to T are section 351 securities. "The basic premise of section 351 of the Code is that transfers to controlled corporations only work changes in form"⁷⁸ Further-

Camp Wolters, 230 F.2d at 560.

73. See, e.g., *Aqualane Shores*, 269 F.2d at 119; *Fleming v. Commissioner*, 25 T.C.M. (CCH) 1284, 1290 (1966); cf. I.R.C. § 267(a)(2) (West Supp. 1986) (denies the taxpayer an interest payment deduction when the interest is owed to a related party but not actually paid, indicating the lack of a bona fide debt).

74. See, e.g., *Fleming*, 25 T.C.M. (CCH) at 1290; *Burr Oaks*, 365 F.2d at 27.

75. See *supra* text accompanying notes 10-12.

76. Without the obligation of having to pay either the principal of \$40,000 or the interest of \$20,000 per year on each note, X would be able to meet its remaining liabilities — X's annual income of \$14,400 is sufficient to meet the yearly expense of \$5000 together with annual mortgage interest payments of \$5000.

77. "A short-term note . . . will be considered securities in circumstances where the stated maturity is either unrealistic . . . or is ignored by the parties." *D'Angelo Assoc., Inc. v. Commissioner*, 70 T.C. 121, 135 (1978).

78. Rev. Rul. 73-472, 1973-2 C.B. 114.

more, one court has stated that

[t]here is, in short, a transfer *in form only*, a technical transfer *not one of substance*. The section is designed to give present tax relief for rearrangements of the taxpayer's own assets, accompanied by *no sacrifice of control* and *no real generation of income* for the owner—and to defer taxation until a true outside disposition is made.⁷⁹

X is an "S" corporation, wholly owned and operated by T. By transferring the property to X, T has not sacrificed control over the property; instead, T has maintained a continuing interest in the property.⁸⁰ Arguably, because of the economic identity between T and X, T's transfer of the property in exchange for X's promissory notes lacks any economic substance. Consequently, the transaction is not a sale of T's assets as required by section 1034, but rather is a mere rearrangement.

Step Transaction Doctrine

In the event that a debt instrument prevails as a bona fide debt, X still may be prohibited from utilizing section 1034's nonrecognition provision if T's transfer of \$10,000 for X's stock and transfer of property for X's promissory notes are treated as two steps of one transaction. Because of the pervasive nature of the step transaction doctrine and the uncertainty as to when and if it will apply,⁸¹ it is important to acknowledge the potential application of the doctrine and its consequences.

The step transaction doctrine is illustrated in *Six Seams Company, Inc. v. United States*.⁸² In that case, the Commissioner, contending that the taxpayer's transaction was not a sale but a section 351 transfer, sought to affirm a tax deficiency judgment arising from the corporate taxpayer's claimed net operating losses. Coiltown, the taxpayer's sole shareholder and parent corporation, transferred cash

79. *Six Seams Co. v. United States*, 524 F.2d 347, 355 (6th Cir. 1975) (emphasis added).

80. *Cf. D'Angelo Assoc., Inc. v. Commissioner*, 70 T.C. 121 (1978). In *D'Angelo*, the taxpayer, a corporation, was established for the purpose of purchasing rental property and equipment from its promoter, D'Angelo. The corporation paid a small amount of the purchase price in cash, assumed an existing mortgage on the property, and issued an interest bearing demand note to D'Angelo for the remainder of the purchase price. Subsequently, the corporation proceeded to claim depreciation deductions based on the step-up in basis obtained by the alleged sale. As of the time of the trial, 16 years after the demand note was issued, only about 50% of the principal had been paid. The court noted further that "[a]s a practical matter, payment of the note was intended to be derived from the rental earnings of the property transferred, a process that would take many years." *Id.* at 134-35. Consequently, the tax court held in favor of the Commissioner, stating: "We believe this record demonstrated a continuing interest by Dr. D'Angelo in the transferred rental property consistent with the policy underlying the nonrecognition provisions of section 351 and unlike that contemplated by a sale." *Id.* at 130.

81. *B. BITTKER & J. EUSTICE, supra* note 63, ¶ 14.51, at 14-130 to 14-132.

82. 524 F.2d 347 (6th Cir. 1975).

in exchange for the taxpayer's stock. On the same day, the taxpayer returned the cash amount to Coiltown under the guise of purchasing certain property, including mining equipment, from Coiltown. Recognizing that "[w]ithout the cash infusion by Coiltown, Six Seam [the taxpayer] would have been unable to 'purchase' the mining equipment," the court refused to treat the stock-for-cash and cash-for-property transactions separately so as to compel recognition of the second transaction as a sale.⁸³ Instead, the court essentially affirmed the tax deficiency judgment, holding that the transactions were merely two steps in an integrated plan to exchange property for stock — a section 351 transfer.⁸⁴

It is possible that the cash-for-stock and the property-for-promissory-notes transactions under the hypothetical also may be treated as a single transaction under section 351 — cash and property in exchange for X's stock with the amount of the promissory notes as "boot."⁸⁵ If this occurs, gain may be recognized up to the value of the boot.⁸⁶ Since T's gain of \$150,000⁸⁷ is less than the amount of boot, \$200,000 (value of the promissory notes), T will recognize the entire \$150,000 as gain. When gain is recognized under section 351, the question arises as to whether the gain will be accorded nonrecognition treatment under section 1034 or denied nonrecognition on the basis that the two Code provisions are mutually exclusive.

As of the writing of this Comment, no authority has yet supported either proposition. At least one commentator, however, has suggested that section 1034 would apply in the instances that gain is recog-

83. *Id.* at 356.

84. *Id.*

85. "Boot" commonly is used to refer to "[c]ash or property of a type not included in the definition of a nontaxable exchange." BLACK'S LAW DICTIONARY 96 (abr. 5th ed. 1983). Under section 351(a), only stock and securities may be received in exchange for T's property in order to qualify as a nontaxable exchange; therefore, since it is assumed that the promissory notes are not securities—and clearly are not stock—they are "other property or money" under section 351(b), otherwise referred to as boot.

86. Section 351(b) states:

If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) The amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

87. Under I.R.C. § 1001(a) (West 1982) gain is computed by subtracting the basis from the sale price. Thus, \$250,000 (the sale price to X) minus \$100,000 (T's basis) yields a gain to T in the amount of \$150,000.

nized under section 351(b).⁸⁸ Because of the lack of authority on this issue, one must be cognizant of the undesirable possibility, under the step transaction doctrine, that a Plan-devised transfer may produce a section 351(b) gain not protected by the nonrecognition provision of section 1034.

Contribution v. Debt

In addition to contending that a certain transaction is a section 351 security, it is not uncommon for the IRS to argue in the alternative that the transaction is a capital contribution. Under section 362(a)(2),⁸⁹ a determination that a transfer is a capital contribution will result in the nonrecognition of a purported sale, similar to a section 351 exchange.⁹⁰ The rationale of the capital contribution argument is that the corporation is thinly capitalized, having a high debt-to-equity ratio. In these instances, the debt incurred from the acquisition of the property is much greater than the corporation's equity. When the acquired property is the primary asset of the corporation, the equity is usually the amount of the corporation's working capital. Accordingly, the IRS contends that the high debt-to-equity ratio creates a degree of risk not unlike that of a shareholder's risk, which is dependent upon the venture's success for the repayment of his investment.⁹¹

It may be observed that a capital contribution argument resembles a section 351 securities argument. In fact, it has been noted that courts have not always been careful to distinguish between these two separate arguments.⁹² Indeed, both arguments require an examination of substantially the same criteria. In *Woolley Equipment Co. v. United States*,⁹³ the court enumerated the following factors as indicative of a capital contribution:

The acquiring corporation is usually undercapitalized; the assets involved in

88. TAX MGMT. (BNA) No. 348, A-35 to A-36 (1985), states as an observation, citing no authority:

If a taxpayer transfers his principal residence to a controlled corporation for stock of the corporation and boot, and an amount equal to the consideration received by the transferor is reinvested in a new principal residence within the requisite period, any gain realized which would otherwise be recognized under § 351(b) may be protected from recognition by § 1034.

89. I.R.C. § 362(a) (West 1978) states:

If property was acquired after June 22, 1954 by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or
(2) as paid-in surplus or as a contribution of capital,
then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

90. *Id.*

91. *E.g.*, *Bradshaw*, 683 F.2d at 373.

92. *Id.* at 372.

93. 268 F. Supp. 358 (E.D. Tex. 1966).

the transfer are usually absolutely essential to the operation of the business of the new corporation; the debts evidenced by the purchase notes are ordinarily subordinated to other debts of the purchaser, or otherwise indicating something other than normal arms-length creditor safeguards; payments on the principal are insignificant or not made at all, and no effort is made by the transferor to compel payment; the maturity date for the notes is inordinately postponed, or the 'interest' is to be paid out of earnings only.⁹⁴

These enumerated factors are substantially similar to those previously mentioned in our discussion of section 351 securities.

In cases in which several of the enumerated factors exist, courts have upheld the IRS capital contribution argument. An illustration of such a case may be found in *Burr Oaks Corp. v. Commissioner*.⁹⁵ In *Burr Oaks*, the taxpayer, a closely held corporation, was formed for the purpose of purchasing land from its shareholders in order to subdivide the land, improve it, and sell lots therefrom. In forming the corporation, the shareholders transferred a total of \$4500 in cash in exchange for the corporation's stock. The corporation purchased the shareholders' land by assuming a \$30,000 preexisting mortgage on the land and issuing two-year interest bearing promissory notes in the amount of \$330,000. The tax court found that the sale of lots was, at best, slow, resulting in the promissory notes not being paid on time and the maturity date on the notes being extended.⁹⁶ Further, the tax court found that the sale price was more than double the fair market value of the land at the time of the purchase and that the corporation had a high debt-to-equity ratio (\$360,000/\$4500).⁹⁷ The Seventh Circuit Court of Appeals, affirming the tax court's findings, held that the transfer of property was not a sale but an equity contribution. The court stated that "[w]hen the payment to the transferors is dependent on the success of an untried, undercapitalized business with uncertain prospects, a strong inference arises that the transfer is an equity contribution."⁹⁸

On the other hand, in cases in which the property transferred is self-liquidating or the activities related to the property are self-income producing, sufficient to pay for the debts incurred, several courts have upheld the transfer as a sale.⁹⁹ In *Bradshaw v. United*

94. *Id.* at 364-65.

95. 365 F.2d 24 (7th Cir. 1966).

96. *Id.* at 26.

97. *Id.* at 27.

98. *Id.*

99. *E.g.*, *Gyro Eng'g Corp. v. United States*, 417 F.2d 437 (9th Cir. 1969) (involving an involuntary conversion under I.R.C. § 1033 (West 1982 & Supp. 1986), a nonrecognition provision similar to section 1034); *Piedmont v. Commissioner*, 388 F.2d 886 (4th Cir. 1968); *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955).

States,¹⁰⁰ the taxpayer formed a wholly owned corporation for the purpose of selling to it land which the corporation subsequently would sell in lots, after subdivision and development. In the formation of the corporation, the taxpayer transferred an automobile valued at \$4500 to the corporation in exchange for the corporation's stock. On the same day, the taxpayer transferred land to the corporation in exchange for five interest bearing promissory notes totalling \$250,000 to be repaid over the course of six and one half years. Unlike the facts in *Burr Oaks*, in *Bradshaw* the purchase price represented the fair market value of the transferred property, the corporation's prospect for financial success practically was guaranteed and in fact, such success was realized, and the corporation paid all of the promissory notes as they came due. With regard to the corporation's high debt-to-equity ratio (\$250,000/\$4500), the court stated that thin capitalization "does not, per se, control the character of the transaction."¹⁰¹ The court stated further that the repayment of the notes did not depend upon the business' success because the property, at all times from the date it was transferred, had a self-liquidating potential for an amount equal to or greater than the total of the promissory notes.¹⁰² Consequently, the court upheld the taxpayer's characterization of the transfer as a sale, and not as a capital contribution.¹⁰³

Under the hypothetical, several factors indicate that the property transfer between T and X may be characterized as a contribution to capital. First, the transferred property is essential to the operation of X's venture — it is X's primary earning asset. Second, the prospects for financial success in X's rental business is nonexistent since the business produces a loss each year. Third, as was previously observed in the discussion of section 351 securities, X is likely to default on its debt payments or postpone the maturity date for the issued notes. Fourth, X's debt-to-equity ratio at twenty-five to one — \$250,000 (debt incurred from the acquisition of the property) divided by \$10,000 (X's equity, that is, the amount of previously contributed capital) — is extremely high, which clearly indicates that the corporation is thinly capitalized. Finally, the transferred property is not likely to be considered self-liquidating, especially when one considers that the reason for X's existence is the lack of a ready and willing buyer. Consequently, these factors support an IRS contention that

100. 683 F.2d 365 (Ct. Cl. 1982).

101. *Id.* at 374.

102. *Id.* at 374-75. The court's conclusion was based both upon the fact that the property was located in an area in which the need for housing was growing and upon the fact that the taxpayer had received several purchase offers prior to the development of the land.

103. *Id.* at 376.

T's transfer of property to X was not a sale, but in actuality was a capital contribution.¹⁰⁴

In summary, the IRS is armed with a number of weapons with which to challenge the characterization of T's property transfer to X as a sale. If successful, whether the challenge is based upon a section 351 security or a capital contribution (and possibly the step transaction doctrine), the result will be the same: T will be prohibited from utilizing section 1034's nonrecognition provision, from taking a step-up in basis for depreciation, and finally from taking a loss deduction on his individual tax return.¹⁰⁵ Conversely, if the IRS is unsuccessful, T will succeed in securing all of the above mentioned tax benefits. Nevertheless, the benefits may be offset upon the disposition of the property to a third party.

SALE OF THE PROPERTY TO A THIRD PARTY

Assuming that a Plan-devised corporation satisfies the business purpose requirement and the initial transfer to the corporation is characterized as a sale, the Plan is completed when a third party buyer is found and a corporate sale of the property follows. The tax consequences which result from the third party sale and the activities thereafter play an important role in determining the viability of the Plan. In analyzing these potential tax consequences a distinction must be made between a corporation's decision to continue in existence or its decision to liquidate.¹⁰⁶

104. *But cf.* I.R.C. § 707(a)(2)(B) (West Supp. 1986) (amended in 1984 in reaction to *Otey v. Commissioner*, 634 F.2d 1046 (6th Cir. 1980)). *Otey* involved facts supporting both a disguised sale between the taxpayer-partner and his partnership, and a capital contribution. The court decided in favor of the taxpayer, holding the transfer to be a capital contribution, not a sale. The 1984 amendment could be interpreted as indicating a legislative preference for treating property in exchange for money or other property as a sale. Nevertheless, although the partnership and corporate code sections are analogous in terms of transfers between the entity and its owners, any legislative preference which can be derived from the amendment of section 707(a) may be limited to the area of partnerships.

105. If the step transaction doctrine is applied, then T may be able to secure both the nonrecognition provision of section 1034, *see supra* note 88, as well as the benefits of a step-up in basis. *See* I.R.C. § 362(a) (West 1978) (basis of the corporation is increased from the transferor's basis by the amount of gain recognized by the transferor).

106. Liquidation is the winding up of a corporation by means of settling its liabilities and distributing its remaining assets to its shareholders. BLACK'S LAW DICTIONARY 479 (abr. 5th ed. 1983).

Continuance of the Corporate Entity

If a Plan-devised corporation elects to remain in existence, it will have to recognize a gain on its disposition of the property. Consequently, it must be determined whether the gain is ordinary gain or long-term capital gain.¹⁰⁷ This distinction between ordinary income and capital gain remains necessary even in the event that the Tax Reform Act of 1986 passes — the Act repeals the special tax treatment afforded to capital gains under section 1202,¹⁰⁸ by taxing all gains as ordinary income—because it is relevant to Code sections other than merely section 1202.¹⁰⁹

Generally, gain derived from the disposition of property held for investment¹¹⁰ or used in the trade or business,¹¹¹ for a period greater than six months,¹¹² will be taxed as a capital gain. But when the gain is derived from the disposition of property held primarily for sale to customers in the ordinary course of business, it will be taxed as ordinary income.¹¹³

In determining whether property is held primarily for sale to customers in the ordinary course of business, the frequency and continuity of sales has been an important and sometimes principal consideration.¹¹⁴ For instance, in cases in which it is undisputed that the taxpayer's purpose for acquiring the property was primarily for sale, a lack of frequency and continuity in sales will persuade a court to hold that the property was not one held primarily for sale to customers in the ordinary course of business.¹¹⁵ This is so because frequency and continuity of sales is considered a strong indication that a taxpayer is in the business of selling the held property; therefore, a single sale has been found to be insufficient for characterizing a parcel

107. Capital gain treatment generally is preferable to ordinary gain because, while ordinary gain is fully taxable, only 40% of the capital gain is subject to tax if the taxpayer is other than a corporation. I.R.C. § 1202 (West 1982). In our hypothetical, because X is an "S" corporation, T is taxed directly and thus, as a noncorporate taxpayer, he is entitled to the 40% treatment.

108. I.R.C. § 1202 (West 1982).

109. H.R. 3838, 99th Cong., 2d Sess. § 301(a) (1986).

110. I.R.C. § 1221 (West 1982).

111. I.R.C. § 1231(a) (West Supp. 1986).

112. I.R.C. § 1222 (West 1982 & Supp. 1986).

113. I.R.C. § 1221(1) (West 1982).

114. *Suburban Realty Co. v. United States*, 615 F.2d 171, 178 (5th Cir. 1980); *Parkside, Inc. v. Commissioner*, 571 F.2d 1092, 1096 (9th Cir. 1977); *Biedenharn Realty Co. v. United States*, 526 F.2d 409, 416-17 (5th Cir. 1976).

Other factors to consider may include:

the extent and nature of the taxpayer's efforts to sell the property; the extent of subdividing, developing, and advertising to increase sales; the use of a business office for the sale of the property; the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and the time and effort the taxpayer habitually devoted to the sales.

United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969).

115. *Winthrop*, 417 F.2d at 911.

of property as being held primarily for sale to customers in the ordinary course of business.¹¹⁶ Thus, a Plan-devised corporation with only one sale, of which the property sold was used in the purported business of renting, is likely to be accorded a capital gain.¹¹⁷

Generally, although a gain from the disposition of property initially may be treated as a capital gain, portions of the gain still may be taxed as ordinary income under section 1250.¹¹⁸ Section 1250 essentially provides for the recapture of past depreciation deductions in excess of the amount allowed under the straight-line method¹¹⁹ by requiring the taxpayer-seller to claim as ordinary income an amount of the gain equal to that of the excess depreciation taken.¹²⁰ Section 1250 applies to depreciable buildings, such as houses used for rental purposes.¹²¹ However, section 1250 is inapplicable since depreciation deductions were taken in accordance with the straight-line method resulting in no excess depreciation.

After disposition of its sole asset, a Plan-devised corporation may proceed to engage in any form of business it so elects. But if the corporation retains its earnings and reinvests in certain passive investments,¹²² it will be subject to a personal-holding company tax of fifty percent on its undistributed income.¹²³ Caution therefore must

116. *Mitchell v. Commissioner*, 47 T.C. 120, 126-27 (1966).

117. For purposes of this section we are assuming that the property transfer from T to X properly was characterized as a sale. Also, it is assumed that X held the property for three years. Thus, X's basis in the property is \$220,000—\$200,000 in promissory notes plus the assumption of a \$50,000 mortgage, *see supra* note 14, minus three years depreciation of \$30,000. *See* I.R.C. § 1016 (West 1982 & Supp. 1986). If it is further assumed that X sells the property to the third party buyer for \$270,000 (including the amount of mortgage assumed by the buyer), the gain subject to tax is \$50,000 (\$270,000 minus \$220,000). Because X is an "S" corporation, the gain passes thru to T, the sole shareholder, and as discussed in the text, it likely would be treated as a capital gain and taxed at 40%. Moreover, because X is a new corporation which has operated as an "S" corporation throughout its entire existence, it is not subject to the minimum tax provision of I.R.C. § 56 (West 1984 & Supp. 1986). *See* I.R.C. § 1363(a) (West Supp. 1986); I.R.C. § 58(d) (West 1984); I.R.C. § 1374(c)(2) (West Supp. 1986). In the event that the Tax Reform Act of 1986 passes, *see* H.R. 3838, 99th Cong., 2d Sess. § 701 (1986) for changes to the minimum tax provisions.

118. I.R.C. § 1250(a)(1) (West 1982 & Supp. 1986).

119. *Id.* § 1250(b)(5).

120. *Id.* § 1250(a).

121. *See supra* note 12.

122. I.R.C. § 543 (West 1967 & Supp. 1986). Passive investments which are subject to a personal-holding-company tax include stocks of other corporations which pay dividends, and certain rent-producing properties in which the rent constitutes less than 50% of the corporation's adjusted ordinary gross income or is greater than 50% but less than the amount of the computed personal-holding-company income which exceeds 10% of the corporation's ordinary gross income for the taxable year. *See id.* § 543(a)(1), (2).

123. I.R.C. § 541 (West Supp. 1986); I.R.C. § 542 (West 1967 & Supp. 1986).

be exercised when considering the corporation's future operation or else the tax savings obtained under the Plan may be defeated.

Liquidation of the Corporation

After disposition of the property, the taxpayer may prefer to liquidate the corporation, having no further use for its existence. The tax consequences of liquidation can best be illustrated by using the hypothetical facts set forth at the beginning of the Comment.

Assume after three years of renting the property X receives \$225,000 in cash from the sale of the property in addition to the buyer's assumption of the original mortgage (assuming the outstanding principal amount due is \$45,000). In pursuit of liquidation, X pays T the entire amount of \$200,000 owed on the promissory notes. The \$200,000 represents the repayment of a debt of which only \$150,000 is gain to T and is not recognized under section 1034.¹²⁴ X's gain from the disposition is \$50,000.¹²⁵ Under section 337(a),¹²⁶ X would not have to pay taxes on the gain if X, under a plan of liquidation, liquidated within twelve months of the sale.¹²⁷ But note that if the Tax Reform Act of 1986 passes, section 337(a) will be repealed.¹²⁸ Furthermore, under section 331,¹²⁹ X's distribution of \$50,000 to T, as X's sole shareholder, is treated as an exchange for stock, not a distribution of dividends. Thus, after deducting \$10,000 for T's basis in the stock,¹³⁰ \$40,000 of the gain is taxed to T as long-term capital gain instead of ordinary income.¹³¹

The favorable tax provisions of sections 337 and 331 will not apply, however, if X is considered a collapsible corporation under section 341.¹³² If X is considered a collapsible corporation, X will be

But see H.R. 3838, 99th Cong., 2d Sess., § 104(b)(8) (1986) which would lower the rate to 38.5% for the 1987 tax year and 28% for all taxable years thereafter.

124. *See supra* note 2.

125. *See supra* note 117.

126. I.R.C. § 337(a) (West 1978 & Supp. 1986).

127. *Id.*

128. H.R. 3838, 99th Cong., 2d Sess., § 631(a) (1986) (repeal of section 337 results in gain recognized to the corporation except in limited circumstances).

129. I.R.C. § 331 (West 1978 & Supp. 1986).

130. I.R.C. § 358(a) (West 1978 & Supp. 1986) (stock in exchange for money is a section 351 transfer subject to the basis provision of section 358).

131. *See* I.R.C. § 1221 (West 1982) (defining capital asset); I.R.C. § 1222 (West 1982 & Supp. 1986) (defining long-term capital gain); I.R.C. § 1202 (West 1982) (stating that only 40% of the gain is taxable). *But see supra* text accompanying note 108 for the possible repeal of capital gain treatment altogether.

132. I.R.C. § 341 (West 1978 & Supp. 1986). The essential characteristics of a collapsible corporation which pertain to our discussion are: (a) the corporation is formed principally for the manufacture, construction, production, or purchase of property; (b) the corporation purchases property which is used in its trade or business, or which is held primarily for sale to customers in the ordinary course of its trade or business; (c) the corporation has not yet realized a substantial part of the gain; and (d) the taxable gain derived from the property is realized by the shareholders, not the corporation, through a

taxed on the \$50,000 gain¹³³ and the subsequent distribution to T will be treated as ordinary income.¹³⁴ However, section 341 only applies to property held for less than three years;¹³⁵ therefore, because X had held the property for three years before selling it, X is not subject to section 341. Consequently, the nonrecognition provision of section 337 and the capital gain allowance of section 331 continue to apply.

Additionally, section 337 does not supersede the section 1250 recapture requirement.¹³⁶ But since X had not taken excess depreciation prior to the disposition of the property, no recapture of previous depreciation deductions is necessary.

It is apparent that the disposition of the property may lead to undesirable tax consequences which may serve to offset the benefits derived from implementing the Plan. But if the corporation is careful by not taking excess depreciation throughout the years of operation, holding the property for three years or more, and, in the event it elects to remain in operation, not reinvesting in certain passive investments, the viability of the Plan from its inception to the closing of the corporation's affairs may be preserved. Nevertheless, despite the Plan's apparent economic viability, it is the legitimacy of the Plan that determines its overall viability.

LETTER RULING 8350084

Proponents of the Plan cite IRS Letter Ruling 8350084 (Ruling)¹³⁷ in support of its legitimacy. The facts in the Ruling involved a proposed sale of the taxpayer's old residence to his wholly owned corporation. In the hands of the corporation, the property would be depreciable. The issue was whether section 1239¹³⁸ applied to the transfer so as to preclude utilization of section 1034.

Section 1239 requires that in situations in which property is trans-

preconceived plan of liquidation. *Id.* § 341(b)(1).

133. I.R.C. § 337(c)(1) (West 1978 & Supp. 1986) (precluding collapsible corporations from obtaining nonrecognition for gain derived from the disposition of property).

134. I.R.C. § 341(a) (West 1978 & Supp. 1986).

135. *Id.* § 341(b)(3). In the event that a Plan-devised corporation holds the property for less than three years before disposition, subsection (e) indicates the exceptions to the application of subsection (a).

136. I.R.C. § 1250(i) (West 1982 & Supp. 1986) ("This section shall apply notwithstanding any other provision of this subtitle.").

137. LTR 8350084 (September 13, 1983). Although a letter ruling does not carry precedential weight, it often may indicate the likely future treatment by the IRS of a similar situation.

138. I.R.C. § 1239 (West 1982 & Supp. 1986).

ferred to a related party, which includes a taxpayer and his wholly owned corporation, and such property is depreciable in the hands of the transferee, the transferor must recognize the gain as ordinary income and not as capital gain.¹³⁹ The IRS ruled that section 1239 would not apply until the taxpayer sold his *new* residence.¹⁴⁰ The IRS ruling was premised on the observation that section 1034 did not specifically prohibit sales between related parties; therefore, if all other requirements are met, the application of section 1034 is mandatory.¹⁴¹

Although the Ruling seems to support the argument that a transfer to a wholly owned corporation is a legitimate and bona fide sale subject to the nonrecognition provision of section 1034, the Ruling does not disclose the nature of the taxpayer's corporation nor does it address the potential applicability of section 351. The corporation very well could have been an existing corporation prior to the time of transfer and in the business of renting or selling homes, or it could have been newly formed for the purpose of the single sale. If the nature of the corporation was the latter, the facts in the Ruling become substantially similar to the layout of the Plan so as to lend support to the legitimacy of the Plan. But if the nature of the corporation was the former situation, the facts would be considerably distinguishable from a Plan-devised corporation since the corporation in the Ruling was a preexisting corporation, perhaps already in the business of renting or selling residential property — an indication of a legitimate corporation with a legitimate business purpose.

In addition to the ambiguity surrounding the nature of the taxpayer's wholly owned corporation, the IRS stated that “[n]o opinion [was] expressed as to the federal income tax consequences of the proposed transaction under the provisions of any other section of the Code.”¹⁴² Since the applicability of section 351 was not raised as an issue in the Ruling, the characterization of the transfer as a section 351 exchange still is plausible, if not inevitable. Consequently, it remains uncertain whether the IRS will leave unchallenged a purported sale involving a new corporation formed for the purpose of the single sale, especially in light of the extremely favorable tax benefits inherent in the Plan.

139. *Id.* See *supra* note 15.

140. “[I]f the new residence is later sold and gain recognized, that gain will be recognized as ordinary income to the extent of the gain that would have been ordinary income were it not deferred upon this sale under section 1034 of the Code.” LTR 8350084 (September 13, 1983).

141. The mandatory nature of section 1034 can be found in Treas. Reg. § 1.1034-1(a) (1956).

142. LTR 8350084 (September 13, 1983).

CONCLUSION

The sale-to-a-related-corporation tax Plan is a risky means of circumventing the two-year limitation provision of section 1034. The Plan requires the formation of a legitimately recognized corporation, but that corporation is likely to be disregarded under the sham transaction doctrine. Furthermore, the Plan necessitates that the transfer between the transferor-shareholder and his Plan-devised corporation be characterized as a sale. The IRS, however, is likely to characterize the transfer as a section 351 exchange or capital contribution. Finally, although proponents of the Plan cite to Letter Ruling 8350084 as supporting the legitimacy of the Plan, a closer analysis indicates that such a conclusion is premature.

In addition to the questionable viability of the Plan under the present tax code, if the Tax Reform Act of 1986¹⁴³ becomes law, the tax savings intended under the Plan will be reduced substantially. In particular, depreciation deductions will be limited to the straight-line method over a longer period of years, thereby lessening the amount of depreciation deductible;¹⁴⁴ losses from rental activities generally will not be deductible for taxpayers grossing more than \$150,000 per year until all interest in the rental activity is disposed;¹⁴⁵ the distinction between capital gains and ordinary income will be eliminated with regard to special tax treatment;¹⁴⁶ and, the nonrecognition of gains to corporations liquidating under section 337 will be repealed.¹⁴⁷ Consequently, not only is the Plan an inviable tax strategy under the current tax code, but in the event that the Tax Reform Act of 1986 becomes law, the tax saving measures intended under the Plan may be so substantially reduced that the benefits of a successful implementation may be all but nonexistent.

ADDENDUM

The Tax Reform Act of 1986 was signed into law on October 22, 1986. When integrated with the old tax code provisions it will be referred to as The Internal Revenue Code of 1986.

As it pertains to the Comment's hypothetical, the new 1986 Code will effect the following changes. First, since under new Code section 469 business and interest expenses are excluded in the determination

143. H.R. 3838, 99th Cong., 2d Sess. (1986).

144. *See supra* note 12.

145. *See supra* text accompanying notes 18-21.

146. *See supra* text accompanying notes 108-09.

147. *See supra* note 128.

of a passive activity's income or losses, X's only deduction is for depreciation (\$10,000). Thus, X's \$25,600 loss, as determined under the pre-1986 Code, is transformed into a *gain* of \$4400 (rental income of \$14,400 minus \$10,000 depreciation) under the new 1986 Code.

Second, although under the new 1986 Code, depreciation generally is limited to the straight-line method over 27.5 years in the case of residential property, it does not apply to pre-1981 property which subsequently is acquired by a related party such as X, a wholly owned corporation. Consequently, X's depreciation deduction of \$10,000, as determined under the straight-line method over a useful life of 25 years, remains unchanged.

Third, because of the repeal of section 337 under the new 1986 Code, double taxation occurs upon X's disposition of the residential property. In particular, X's \$50,000 gain is taxed to X at the time of the sale as well as to T upon distribution of X's assets in accordance with X's liquidation.

Finally, because the new 1986 Code eliminates special tax treatment for capital gains, the \$50,000 gain recognized by X upon disposition of the residential property and later by T upon X's distribution of assets pursuant to a liquidation, is taxed as ordinary income.

As illustrated above, the new 1986 Code, especially section 469, will reduce substantially and in some cases, defeat entirely, the Plan's economic viability.

MARY TSENG